

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
Zenith National Insurance Corp.) No. 94A-0767
)

Representing the Parties:

For Appellant: Anthon S. Cannon, Jr.,
 Attorney

For Respondent: Edward J. Kline, Counsel

Counsel for Board
of Equalization: Derick J. Brannan, Tax
Counsel

O P I N I O N

This appeal is made pursuant to section 19045¹ of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Zenith National Insurance Corporation against proposed assessments of additional franchise tax in the amounts of \$50,110.24, \$199,271.49, \$207,646.62 and \$254,690.00 for the income years ended December 31, 1982, December 31, 1983, December 31, 1984, and December 31, 1985, respectively. The basic issue on appeal is whether interest expense incurred in connection with the issuance of corporate debentures should be allocated to taxable or nontaxable income for purposes of determining the deductibility of that expense.

During the subject income years, appellant owned all of the stock in the Zenith Insurance Company (hereafter ZIC).
ZIC

¹Unless otherwise specified, all section references in the text of this opinion are to sections of the Revenue and Taxation Code in effect for the income years in issue.

held a license to conduct insurance business in the State of California and was subject to the California tax on gross insurance premiums; as a result, ZIC dividends paid to appellant were not included in appellant's measure of tax pursuant to section 24410. (See Rev. & Tax. Code, Part 7, § 12001 et seq., and Part 11, § 23001 et seq.) Further, because section 24425 precludes a deduction for any expense allocable to a class of income which is not subject to the Bank and Corporation Tax, to the extent that appellant incurred expenses allocable to dividend income from ZIC, those expenses would not be deductible.

During the subject income years, appellant incurred significant interest expense in connection with the issuance of corporate debentures. Appellant used the debenture proceeds to develop a diverse portfolio of preferred stock. The preferred stock generated dividend income which was taxable pursuant to the California Bank and Corporation Tax, and on that basis, appellant deducted all of its debenture-related interest expense. On audit, respondent reallocated appellant's interest expense deductions between appellant's income from the preferred stock dividends and its income from the ZIC dividends. Respondent utilized a formula to allocate the interest expense in accordance with the ratio of appellant's insurance-related income (income excluded from the bank and corporation tax) to appellant's gross income (all income whether excluded or not). Appellant disputes the use of this general allocation formula, and the basic issue on appeal is how properly to allocate, if at all, the debenture interest expense between appellant's taxable and nontaxable activities.

On September 9, 1982, appellant's Board of Directors generally discussed the infusion of additional capital into the company in order to enhance its stature and earnings. At a subsequent meeting, the Board of Directors approved the issuance of debentures with a face value of \$50 million; the minutes for that meeting do not contain any reference as to the specific intended use for the debenture proceeds. However, the offering brochure which accompanied the debentures indicated as follows:

"The offering will provide funds which will be available for general corporate purposes. A portion of the proceeds may be used for the

repayment of [appellant's] or ZIC's bank indebtedness, aggregating \$18,500,000 at September 30, 1982, of which approximately \$3,260,000 is due in 1983. A portion of the proceeds may also be loaned or contributed to ZIC for additions to its investment portfolio or may be used by [appellant] for possible acquisitions. [Appellant] is not currently engaged in any acquisition discussions. For such purposes [appellant] may incur additional indebtedness."

In slight contrast to the general language contained in the brochure, appellant offers a number of declarations from key executives to the effect that appellant issued the debentures with the dominant purpose of investing the proceeds in preferred stock, and in turn, gaining the federal tax advantages of the intercorporate dividend deduction.

On October 15, 1982, appellant issued debentures with a face value of \$50 million and which generated net proceeds of \$47,847,000. In November of 1982, shortly after it received the debenture proceeds, appellant paid off \$8.5 million in short term bank debt, purchased some additional short term money market investments and advanced \$15 million to ZIC; ZIC repaid those funds with interest between December 1982 and January 1983. By March 31, 1983, less than six months after it issued the debentures, appellant had amassed a portfolio of preferred stock valued at \$49.6 million.

Between September and December of 1983, appellant's board increased various lines of credit and guaranteed certain indebtedness of ZIC. Thereafter, ZIC used proceeds from a loan guaranteed by appellant in order to repay a loan from appellant; ZIC also used similar proceeds to increase its own insurance reserves. In spite of this mutually beneficial financing, appellant's president testified under oath at the hearing that the debenture proceeds were "totally separable" from appellant's other banking activities, "because there really [were] no other liquid assets in the [appellant]."

Further, appellant never sold any of its preferred stock to meet ZIC's financial needs.

The preferred stock portfolio remained relatively stable in value until July of 1985. At that time, appellant successfully bid \$40 million for the CalFarm Insurance Company (hereafter CalFarm). Upon acceptance of its bid, appellant liquidated the preferred stock portfolio in order to pay the bid price for CalFarm. Appellant subsequently issued its own preferred stock which raised roughly \$135 million; from that

money, appellant contributed \$80 million to ZIC, paid \$32 million to repay other bank loans and invested roughly \$23 million in other short term securities and preferred stock.

During the subject income years, appellant deducted interest expense stemming directly from the debentures of \$2,815,886 in 1982, \$8,597,697 in 1983, \$8,333,261 in 1984, and \$8,439,205 in 1985. While holding the portfolio, appellant also incurred administrative and banking expenses which it claims were necessary to monitor and maintain the portfolio, and which it also seeks to deduct as allocable to the taxable income stemming from the portfolio.

Section 24425 precludes a deduction for any amount, "which is allocable to one or more classes of income not included in the measure of the [Bank and Corporation] tax." The Internal Revenue Code (hereafter IRC) contains a similar provision at section 265(a)(1), which precludes a deduction for expenses allocable to tax exempt income (other than tax exempt interest income). (See Treas. Reg. § 1.265-1(a)(1).) The purpose of these allocation provisions is to separate excludable income from includible income, in order that a double exemption may not be obtained through the reduction of includible income by expenses incurred in the production of wholly excludable income. (Great Western Financial Corp. v. Franchise Tax Board (1971) 4 Cal.3d 1, 6.)

The parties agree that Internal Revenue Service (hereafter IRS) regulations supporting IRC section 265(a) provide the proper test to resolve this appeal. Those regulations provide as follows:

"[1] Expenses and amounts otherwise allowable which are directly allocable to any class or classes of exempt income shall be allocated thereto; and [2] expenses and amounts directly allocable to any class or classes of nonexempt income shall be allocated thereto. [3] If an expense or amount otherwise allowable is indirectly allocable to both a class of nonexempt income and a class of exempt income, a reasonable proportion thereof determined in the light of all the facts and circumstances in each case shall be allocated to each."

(Treas. Reg. § 1.265-1(c) (1958) [emphasis added].) Appellant argues that the debenture interest expense can be directly allocated to the income generated by its preferred stock portfolio, and is therefore deductible. Appellant also argues

that prior Board opinions establish a purpose and/or use test for determining the means by which certain expenses may be allocated to income-producing activities. Regardless of the applicable test, appellant argues that its dominant purpose for incurring the interest expense was to finance taxable activities, and that in fact, it did use the debenture proceeds for such activities.

In support of its position that this Board should look to the taxpayer's purpose in securing the debenture proceeds (and incurring the related interest), appellant refers to the Appeal of Southern California Central Credit Union, decided by this Board on February 3, 1965. In that case, the Board determined that the taxpayer's purpose in securing funds was to meet the demands of its credit union members for loans. Therefore, the Board allocated the cost of borrowing such funds to business done with the members, a non-taxable activity. On that basis, the interest expense incurred in connection with those funds could not be deducted against taxable income.² (See also Appeal of Los Angeles Firemen's Credit Union, Inc., Cal. St. Bd. of Equal., June 28, 1966.) According to appellant, if the Board applies this purpose test to the instant case, it should prevail based on the evidence of its intent at the time it issued the debentures and acquired the preferred stock portfolio.

Both parties suggest that this Board may have adopted a use test for purposes of determining the deductibility of certain expenses. Pursuant to the use test, "the question is what income did the expense in controversy help to produce, not what use was the income put to." (Appeal of Mission Equities Corp., Cal. St. Bd. of Equal., Jan. 7, 1975.)³ In our opinion, the use test, arguably suggested by the Mission Equities decision, amounts to

²Respondent suggests that it is not clear that the Appeal of Los Angeles Firemen's Credit Union, Inc., Infra, adopts a "purpose" test. Regardless of the precise holding of that opinion, it is clear from the language of the opinion that the Board relied heavily on the taxpayer's exempt purpose for obtaining the funds in reaching a decision. Respondent further suggests that the opinion is distinguishable from the instant case because it concerns a credit union; while that factual difference is obvious, it is not significant. We are here concerned with the allocation principles discussed in that case, not the factual similarities (or lack thereof).

³After enunciating this rule, the Board based its final determination on the fact that the taxpayer's subsidiary had already deducted expenses in connection with the excluded income. For that reason, the Board found that it would be improper to allow a double deduction, one for the subsidiary and one for the parent, in connection with the same income.

an accounting test which seeks to trace the application of the subject funds. We do not view that test as distinct from the purpose inquiry set forth in our other opinions. Rather, and as will be explained later, the two inquiries are complementary for purposes of establishing the proper allocation of interest expense. (See E.F. Hutton Group, Inc. v. United States (1987) 811 F.2d 581, 584.)

Appellant also argues that various IRS pronouncements support its position. More specifically, Revenue Ruling 83-3 addresses the deductibility of expenses paid from tax exempt income; the ruling suggests certain allocation methods based on the purpose of the underlying expenditures. (Rev. Rul. 83-3, 1983-1 C.B. 72.) Appellant further cites Revenue Procedure 72-18, which discusses IRC section 265(a)(2) and sets forth guidelines for allocating indebtedness and the related interest expense between tax-exempt securities and other taxable activities. That procedure implements the allocation process by focusing on the taxpayer's purpose in acquiring the indebtedness as demonstrated by all of the facts and circumstances, including the actual use of the debt proceeds. (Rev. Proc. 72-18, 1972-1 C.B. 740; see also Treas. Reg. § 1.265-2(a).)

In contrast to appellant's position, respondent argues that interest, by its nature, is not susceptible to direct allocation. In other words, respondent contends that because money is fungible, such that money generated from two distinct sources is indistinguishable once it is placed in the same fund, any determination regarding the purpose or use of the debenture proceeds will be tenuous at best, and of only limited value for allocation purposes. Further, because the interest expense stems from money which is subject to the discretionary use of the taxpayer, the interest expense simply cannot be directly allocated to a particular class of income, rather, the expense contributes to all aspects of the corporate operations. (See Appeal of Pacific Associates, Inc., Cal. St. Bd. of Equal., Feb. 2, 1976.) For these reasons, when applying Treasury Regulation section 1.265-1(c), supra, respondent argues that interest may only be indirectly allocated by way of a formula which allocates a reasonable portion of the interest expense to both taxable and nontaxable of income.

Respondent also argues that appellant's various uses of the debenture proceeds for items unrelated to the preferred stock, such as the short term loan to ZIC or the CalFarm purchase, demonstrate that appellant never intended to restrict

those funds to one taxable purpose. Respondent also contends that these additional transactions support its position that the associated interest expense is difficult (if not impossible) to allocate between appellant's various income-producing activities. Finally, according to respondent, the fact that appellant chose not to use the proceeds from the preferred stock to retire the debentures constitutes further evidence that appellant intended to use the funds for both taxable and nontaxable purposes.

Each party presents valid arguments in support of its position, and each argument is founded upon meritorious considerations. It is our opinion that the principles set forth in Revenue Procedure 72-18 best implement all of those considerations, will provide the most workable solution over the long term, and are not inconsistent with our existing opinions in this area. Revenue Procedure 72-18 focuses on the taxpayer's dominant purpose for incurring and continuing the subject indebtedness, but also considers the actual use of the debt funds as strong evidence of that purpose.⁴ "Direct evidence of a purpose to purchase tax-exempt obligations [or taxable investments] exists where the proceeds of indebtedness are used for, and are directly traceable to, the purchase." (Rev. Proc. 72-18, supra, §§ 3.02 and 3.03.)

In the absence of direct evidence linking indebtedness with a particular purchase, the IRS, and this Board, will determine whether the totality of the facts and circumstances establish a sufficiently direct relationship between the borrowing and the investment to allow for a direct allocation between those two items. (Rev. Proc. 72-18, supra, § 3.04.) Unless the taxpayer can establish its dominant purpose and a sufficiently direct relationship between the expense and the income, respondent's allocation formula will provide the best means to allocate interest expense between taxable and nontaxable activities. Further, due to the factual nature of the inquiries presented by this analysis, it is also clear that the taxpayer must carry the general burden of proving its dominant purpose for incurring and/or continuing the subject obligations (and the related interest expense), as well as the burden of demonstrating

⁴We understand that IRC section 265(a)(2), by its terms, applies to tax exempt obligations and does not necessarily apply to the case at hand. However, we also note that section 265(a)(2) and its supporting regulatory scheme concern the allocation of interest expense between taxable and nontaxable activities. For that reason, we find that Revenue Procedure 72-18, and the principles upon which it relies, provide the most helpful framework within which to resolve the present case.

the actual use of the subject funds, by tracing or some other method.

Applying these rules to the instant case, we find that appellant has established a dominant purpose sufficient to allow for a direct allocation of its interest expense for the 1982, 1983 and 1984 income years, but has not done so with regard to the 1985 income year.

Regarding 1982, 1983 and 1984, the declarations submitted by appellant, as well as the live testimony of appellant's president, clearly establish appellant's motivation for incurring, and continuing, the debenture interest expense as well as its intentions for the debenture proceeds. That motivation is further established by the uncontroverted evidence that appellant used all of the debenture proceeds to acquire a portfolio of preferred stock within six months of the debenture issue date. Because appellant realized taxable income from that preferred stock, the interest incurred in carrying the debenture obligations is directly allocable to the taxable income generated by the preferred stock portfolio, and is therefore deductible.

Respondent argues that appellant's use of the debenture funds to support ZIC during the 1983 income year, either through direct financing or through loan guarantees, is inconsistent with appellant's asserted dominant purpose. Respondent's point is not without merit; however, a temporary diversion of funds will not, of itself, alter the dominant purpose for incurring the indebtedness represented by the debentures. (Rev. Proc. 72-18, supra, § 3.02.) Further, once purchased, appellant never sold any of the preferred stock in order to finance the loans to ZIC, and each of the subsequent loans to ZIC generated taxable interest income at the market rate. Finally, the simultaneous pursuit of two activities is not, in and of itself, sufficient to trigger a disallowance of the expense under the applicable statute; the taxpayer may still offer sufficient evidence to allow for a direct allocation. (Handy Button Machine Co. v. Commissioner (1974) 61 T.C. 846, 852.)

Respondent points out that interest is traditionally considered an indirect expense for financial accounting purposes, which by definition cannot be directly allocated to a particular item or activity. First, financial accounting is distinct from tax accounting and will take us only so far in arriving at a legal conclusion. Second, we recognize that the distinction between direct and indirect expenses, and the allocation of those

expenses, can be difficult. However, such complexities should not preclude a taxpayer from presenting sufficient evidence to obtain a proper tax benefit; slavish adherence to somewhat arbitrary rules should not come at the cost of the correct result.⁵ Finally, respondent suggests that its reasonable formula provides certainty and eases its administrative burden. While formulas are often easier to implement, the burden of producing evidence sufficient to demonstrate the requisite dominant purpose still rests with the taxpayer; therefore, we conclude that our holding does not unnecessarily add to respondent's existing administrative burden.

As to the 1985 income year, we are not satisfied that appellant maintained, or continued with, the dominant purpose sufficient to allocate the subject interest expense entirely to income from its "taxable" activities. The facts demonstrate that appellant sold nearly all of its preferred stock portfolio in order to acquire CalFarm; it did not use the proceeds to retire the debentures, rather, it acquired yet another insurance company whose income is not subject to the California Bank and Corporation Tax. After liquidating the preferred stock portfolio, appellant issued its own preferred stock and raised roughly \$135 million. Of that amount, appellant contributed \$80 million to ZIC, repaid \$32 million in other bank loans and invested roughly \$23 million in other short term securities and preferred stock. The record does not contain a detailed breakdown of the type of securities acquired by appellant, but it is evident that the nature of appellant's holdings changed dramatically as a result of the CalFarm acquisition. In short, we lose sight of the debenture proceeds in 1985. For that reason we are no longer content to rely on appellant's original dominant purpose for continuing the debt, and we find that the interest expense is no longer directly allocable to income from appellant's taxable activities. For these reasons, appellant's 1985 interest expense should be allocated in accordance with the formula utilized by respondent in arriving at its assessment for that income year.

As one final matter, the parties also dispute the proper allocation of administrative expenses incurred by appellant in connection with the debentures and the preferred stock portfolio. We find that these expenses should be allocated in the same manner as the interest expense based on the rationale set forth above.

⁵While it should be evident, this rule may also operate to the detriment of a taxpayer whose purpose in incurring certain debt is sufficiently clear that the related interest expense may be directly allocated to tax exempt income.

Based upon the above analysis and factual conclusions, we hereby reverse respondent's determination as to the 1982, 1983 and 1984 income years, and affirm its determination as to the 1985 income year.

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED, AND DECREED, pursuant to section 19047 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Zenith National Insurance Corporation against proposed assessments of additional franchise tax in the amounts of \$50,110.24, \$199,271.49, and \$207,646.62 for the income years ended December 31, 1982, December 31, 1983, and December 31, 1984, respectively, be and the same is hereby reversed, and that the Franchise Tax Board's action on the protest against the proposed assessment of \$254,690.00 for the income year ended December 31, 1985, be sustained.

Done at Sacramento, California, this 8th day of January, 1998, by the State Board of Equalization, with Board Members Mr. Andal, Mr. Klehs, Mr. Dronenburg, Mr. Halverson* (not participating) and Mr. Chiang** present.

Dean F. Andal, Chairman

Johan Klehs, Member

Ernest J. Dronenburg, Jr., Member

, Member

John Chiang**, Member

*For Kathleen Connell, per Government Code section 7.9.

**Acting Member, 4th District.